# No. 15,587

# United States Court of Appeals

## For the Ninth Circuit

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JOHN COSTELLO, Trustee in Bankruptcy of Leonard Plumbing and Heating Supply, Inc., bankrupt,
*Appellant,*

vs.

J. A. FAZIO and LAWRENCE C. AMBROSE,
*Appellees.*

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**Appeal from Order of United States District Court, Northern District of California, Southern Division, Confirming Referee in Bankruptcy's Order Overruling Trustee's Objections to Claims of J. A. Fazio and Lawrence C. Ambrose.**

## APPELLANT'S OPENING BRIEF.

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## APPELLANT'S OPENING BRIEF.

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### JURISDICTION.

This is an appeal from an order of the United States District Court, Northern District of California, affirming the order of the Honorable Bernard J. Abrott, one of its referees in bankruptcy, overruling the trustee's objections to the proofs of the claims of J. A. Fazio and Lawrence C. Ambrose, claimants and appellees.

Jurisdiction generally is sustained under Section 39c of the Bankruptcy Act (11 U.S.C. Sec. 67c) which

provides for review of orders of a referee by a judge, and by Section 2a (2) of said Act (11 U.S.C. Sec. 11a (2)) which vests the District Court with jurisdiction to reconsider allowed or disallowed claims.

Jurisdiction of this Court to review the order of said District Court is conferred by Section 24 of the Bankruptcy Act (11 U.S.C. Sec. 47) which vests United States Courts of Appeals with appellate jurisdiction from the several Courts of Bankruptcy within their respective jurisdictions in controversies arising in proceedings in bankruptcy.

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## STATEMENT OF THE CASE.

The bankrupt corporation was originally organized as a partnership in October, 1948, the Certificate of Fictitious Name showing J. A. Fazio, Lawrence C. Ambrose and B. T. Leonard doing business under the fictitious name of "Leonard Plumbing & Heating Supply Co." No written agreement of partnership was entered into but apparently the partners all agreed to share equally in profits. The original capital contributions of the partners consisted of the following:

J. A. Fazio—Inventories valued at $39,606.40;

L. C. Ambrose—Cash in the sum of $4,000.00;

B. T. Leonard—Cash in the sum of $1,200.00 (this contribution seemingly having been withdrawn in the first year). (Trustee's Exhibit 4.) (Claimant's Exhibit No. 2.)

With the close of the fourth year of operation in which the partnership suffered a net loss of $22,521.34, the decision was made to incorporate and Articles of Incorporation were filed on September 22, 1952, under the name of "Leonard Plumbing & Heating Supply, Inc." Shortly before incorporation the capital accounts of the partners stood as follows:

J. A. Fazio—$43,169.61;

L. C. Ambrose—$6,451.17;

B. T. Leonard—$2,000.00. (Trustee's Exhibit 4.)

On September 15, 1952, just 7 days prior to the filing of Articles of Incorporation, the partnership gave J. A. Fazio a promissory note for $41,169.61, and L. C. Ambrose a promissory note for $4,451.17, at the same time reducing the capital accounts of both to $2,000.00. (Trustee's Exhibits 4, 5; Claimant's Exhibit 4.) The closing balance sheet showed the partnership to be subject to current liabilities of $162,162.22 (including the liabilities represented by the notes to partners) which was balanced by current assets of but $160,-791.87 (represented mostly by inventory). (Trustee's Exhibit 3.)

The corporation was capitalized for 600 shares of no par value common stock valued at $10.00 per share, and on application to the Commissioner of Corporations of the State of California a permit was issued authorizing the issuance of 200 shares of the stock to each of the partners in consideration for the transfer of the business and assets of the partnership, subject to the usual escrow provision. (Trustee's Exhibit 2.)

No further capital contributions were made by the partners (now shareholders) and no consideration was given for the corporation's stock other than the transfer of the partnership business, in which the current liabilities exceeded the current assets at the time of transfer. (Trustee's Exhibit 2.)

After suffering continued losses, the corporation made an assignment for the benefit of creditors to the San Francisco Board of Trade in June of 1954 and on October 8, 1954, it filed a voluntary petition in bankruptcy. On March 18, 1955, two claims were filed by J. A. Fazio against the bankrupt estate, one in the sum of $34,147.55 based upon the promissory note and the other in the sum of $21,851.87 contingent upon a secured claim to American Trust Company upon whose note Fazio stood as surety. On March 28, 1955 a claim was filed by Lawrence C. Ambrose in the sum of $7,871.17, based upon the promissory note similarly issued by the partnership just before incorporation. Discrepancies between the value of these claims and the amount of the notes to claimants is due to certain set-offs against the corporation and transfers between Fazio and Ambrose personally. It is the claims of Fazio and Ambrose which the trustee now seeks to subordinate to the claims of other general creditors.

After hearings were held on January 17, January 25 and February 13, 1956, the referee in bankruptcy rendered his findings of fact, conclusions of law and judgment on August 28, 1956, wherein it overruled the trustee's objections to the proofs of the claims of J. A. Fazio and Lawrence C. Ambrose, claimants and ap-

pellees. Thereafter appellant petitioned the Court below for a review of the referee's order, which, after a hearing and without opinion, affirmed the referee's order.

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## SPECIFICATIONS OF ERROR.

The points upon which appellant relies are that:

1. The District Court erred in affirming the order of the Referee in Bankruptcy overruling the trustee's objections to the proofs of the claims of J. A. Fazio and L. C. Ambrose (Lawrence C. Ambrose).

2. The District Court erred in holding that there is substantial evidence in the record to sustain the findings of the Referee in Bankruptcy. In particular the District Court erred in holding that the first, fourth, fifth, sixth, seventh, ninth, tenth and eleventh findings contained therein are supported by the evidence.

3. The District Court erred in not finding that the proofs of the claims of J. A. Fazio and L. C. Ambrose (Lawrence C. Ambrose) if allowed at all, should be subordinated to those of other unsecured creditors.

4. The District Court erred in not finding that the obligations upon which the claims of J. A. Fazio and L. C. Ambrose (Lawrence C. Ambrose) were founded were conditional obligations to pay a debt out of an uncertain fund, which fund never came into existence.

5. The District Court erred in denying the relief prayed for in the Trustee's Objections to the Proofs

of Claims filed by J. A. Fazio and Lawrence C. Ambrose (L. C. Ambrose) herein.

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## SUMMARY OF THE ARGUMENT.

The two claimants and appellees in this case are controlling shareholders of the bankrupt. These claims arise out of purported loans to themselves at the time the partnership was reorganized as a corporation; that is, at the time of incorporation the partners gave notes to themselves in the approximate value of their original capital contributions to the partnership.

It is the contention of the trustee and appellant that such claims of controlling shareholders should be deferred or subordinated to the claims of outside unsecured creditors where the corporation was thus inadequately or not honestly capitalized. This principle of law has become known as the "Deep Rock Doctrine" since its application by the United States Supreme Court in *Taylor v. Standard Gas & Electric Co.,* 306 U.S. 307.

Furthermore, admitted capital contributions cannot, as a matter of law, be later converted into debt obligations by the simple expedient of taking back promissory notes for such capital advances so that the contributors can participate with general unsecured creditors when the business later goes into bankruptcy. To do otherwise would be unfair and inequitable to those creditors.

A final argument against the allowance of appellees' claims is based upon the principle that a conditional obligation to pay a debt out of an uncertain fund does not accrue until the condition is performed. When the testimony is undisputed that the claims of J. C. Fazio and Lawrence C. Ambrose were to be "liquidated out of profits" and when such profits never arise, as was the case here, the claims fall within the above rule and are thus not provable in bankruptcy.

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## ARGUMENT.

### I.

### CLAIMS OF CONTROLLING SHAREHOLDERS WILL BE DEFERRED OR SUBORDINATED TO OUTSIDE CREDITORS WHERE A CORPORATION IN BANKRUPTCY HAS NOT BEEN ADEQUATELY OR HONESTLY CAPITALIZED OR HAS BEEN MANAGED TO THE PREJUDICE OF CREDITORS OR TO DO OTHERWISE WOULD BE UNFAIR TO CREDITORS.

> ". . . The courts will scrutinize the good faith and fairness of a transaction by which the controlling shareholders seek to recover a purported loan to themselves in what is their own business in competition with other creditors, and will consider the adequacy of the capital furnished and other circumstances." (Ballantine on Corporations, 2d Ed. Sec. 129, p. 301.)

The question most frequently arises where a parent corporation seeks to recover loans or other claims in the bankruptcy of its subsidiary corporation. Such was the situation in *Taylor v. Standard Gas & Electric Co.*, 306 U.S. 307, known as the "Deep Rock" case, and

which name has been generally applied to the above proposition, now referred to as the "Deep Rock Doctrine."

> *Taylor v. Standard Gas & Electric Co.,* 306 U.S. 307, 59 Sup. Ct. 543, 83 L. Ed. 699.

Here a subsidiary of Standard, the Deep Rock Oil Corporation, was in bankruptcy proceedings under sec. 77B. In the plan of reorganization Standard sought to recover open account claims along with other creditors and in preference to preferred shareholders. The Court found that Deep Rock had been insufficiently capitalized and held that the claim of the parent should be subordinated to those of other creditors and preferred shareholders because the parent had not provided the debtor corporation with adequate capital and had also engaged in certain abuses of management prejudicial to such creditors. In reversing the lower Courts the Supreme Court (Justice Roberts) made the following observations:

> "In the present case there remains an equity after satisfaction of the creditors in which only the preferred stockholders and Standard can have an interest. Equity requires the award to preferred stockholders of a superior position in the reorganized company. (p. 323.)
>
> Deep Rock finds itself bankrupt not only because of the enormous sums it owes Standard but because of the abuses in management due to the paramount interest of interlocking officers and directors in the preservation of Standard's position, as at once proprietor and creditor of Deep Rock. It is impossible to recast Deep Rock's his-

tory and experience so as even to approximate what would be its financial condition at this day had it been adequately capitalized and independently managed and had its fiscal affairs been conducted with an eye single to its own interests. (p. 323.)

If a reorganization is effected, the amount of which Standard's claim is allowed is not important if it is to be represented by stock in the new company, provided the stock to be awarded it is subordinated to that awarded preferred stockholders. No plan ought to be approved which does not accord the preferred stockholders a right of participation in the equity in the company's assets prior to that of Standard, and at least equal voice with Standard in the management. Anything less would be to remand them to precisely the status which has inflicted serious detriment on them in the past." (p. 324.)

Shortly after the *Deep Rock* case the underlying principle was applied by the U.S. Supreme Court to individual stockholders in one-man or close corporations. This arose in *Pepper v. Litton,* 308 U.S. 295; 60 Sup. Ct. 238; 84 L. Ed. 281, in which the Court was dealing with an attempt of an *individual owner of a bankrupt corporation to prove a claim against it as a creditor*. The controlling shareholder's claim was in the form of a confessed judgment of salary claims. The claims had been dormant for five years and the claimant sought to perfect them only when bankruptcy was eminent. In disallowing the claim the Court relied on the *Deep Rock* case and then went on to enunciate in broad terms the fiduciary duties of a controlling

shareholder, violation of which would cause his claim to be subordinated, saying (Justice Douglas):

"That equitable power also exists in passing on claims presented by an officer, director, or stockholder in the bankruptcy proceedings of his corporation. The mere fact that an officer, director, or stockholder has a claim against his bankrupt corporation or that he has reduced that claim to judgment does not mean that the bankruptcy court must accord it pari passu treatment with the claims of other creditors. Its disallowance or subordination may be necessitated by certain cardinal principles of equity jurisprudence. A director is a fiduciary. *Twin-Lick Oil Company v. Marbury,* 91 U.S. 587, 588, 23 L.Ed. 328. So is a dominant or controlling stockholder or group of stockholders. *Southern Pacific Company v. Bogert,* 250 U.S. 483, 492, 39 S.Ct. 533, 537, 63 L.Ed. 1099. Their powers are powers in trust. See *Jackson v. Ludeling,* 21 Wall. 616, 624, 22 L.Ed. 492. Their dealings with the corporation are subjected to rigorous scrutiny and where any of their contracts or engagements with the corporation is challenged the burden is on the director or stockholder not only to prove the good faith of the transaction but also to show its inherent fairness from the viewpoint of the corporation and those interested therein. *Geddes v. Anaconda Copper Mining Company,* 254 U.S. 590, 599, 41 S.Ct. 209, 212, 65 L.Ed. 425. The essence of the test is whether or not under all the circumstances the transaction carries the earmarks of an arm's length bargain. If it does not, equity will set it aside. * * *

As we have said, the bankruptcy court in passing on allowance of claims sits as a court of

equity. Hence these rules governing the fiduciary responsibilities of directors and stockholders come into play on allowance of their claims in bankruptcy. In the exercise of its equitable jurisdiction the bankruptcy court has the power to sift the circumstances surrounding any claim to see that injustice or unfairness is not done in administration of the bankrupt estate. And its duty so to do is especially clear when the claim seeking allowance accrues to the benefit of an officer, director, or stockholder * * * (This result) is reached where the claim asserted is void or voidable because the vote of the interested director or stockholder helped bring it into being or where the history of the corporation shows dominancy and exploitation on the part of the claimant. It is also reached where on the facts the bankrupt has been used merely as a corporate pocket of the dominant stockholder, who, with disregard of the substance or form of corporate management, has treated its affairs as his own. And so-called *loans or advances by the dominant or controlling stockholder will be subordinated to claims of other creditors and thus treated in effect as capital contributions by the stockholder not only in foregoing types of situations but also where the paid-in capital is purely nominal, the capital necessary for the scope and magnitude of the operations of the company being furnished by the stockholder as a loan.*

Though disallowance of such claims will be ordered where they are fictitious or a sham, these cases do not turn on the existence or non-existence of the debt. Rather they involve simply the question of order of payment." (U.S. 306-310.)

The process was carried to its final phase in *Arnold v. Phillips,* 117 F. 2d 479 (C.C.A. 5th, 1941) (cert. den. 313 U.S. 583, 85 L.Ed. 1539), where the principles were applied in the case of an individual shareholder so as to deny him the position of creditor with respect to moneys advanced at the time of the organization of the corporation. This case presented a problem in which the shareholder-creditor had made two series of advances to the corporation. The first series was made at or near the time of incorporation, but the second series was made some four years later during a period of reverses after the company had had two years of prosperity. The corporate charter provided for an original capitalization of $50,000, but an additional $70,000 was loaned by the shareholder-creditor for completion of a brewery, which was the corporation's primary asset. Four years later additional advances were made to provide operating capital. On bankruptcy the Court treated the original advances as stock subscriptions or invested capital, following the *Deep Rock* case, but sustained the shareholder's claim with respect to the loans made by him to the corporation subsequent to its organization. In setting aside the creditor's foreclosure sale the Court observed that:

> "The two series of advances differ materially as respects their nature and purpose. Those made before the enterprise was launched were, as the district court found, really capital. Although the charter provided for no more capital than $50,000, what it took to build the plant and equip it was a permanent investment, in its nature capital. There was no security asked or given. Arnold saw

> that he could not proceed with his enterprise unless he enlarged the capital. There can be little doubt that what he contributed to the plant was actually intended to be capital, notwithstanding the charter was not amended and demand notes were taken. The district court was justified in concluding as a matter of fact that the advances during the first year were capital, a sort of interest-bearing redeemable stock; and that as a matter of law these contributions could not, as against corporate creditors, either precedent or subsequent, be turned into secured debts by afterwards taking and recording a trust deed to secure them. There was no debt to be secured." (117 F.2d 497.)

In passing the Court also observed that in such situations the federal bankruptcy law, rather than state law, is controlling.

While inadequate capitalization is ordinarily accompanied by some other types of mismanagement it is, of itself, sufficient to warrant subordination. It has been observed that judicial disapproval of the inadequately capitalized concern did not commence with the *Deep Rock* case. Even before, bankruptcy and equity receivership Courts were refusing a creditor's status to the creator of a corporation who put in venture capital predominately in the form of creditor obligations. (See 42 Col. L. Rev. 1124 at 1129 and cases cited therein; *Carter v. Bogden,* 13 F. 2d 90; *Manhattan Trust Co. v. Seattle Coal & Iron Co.,* 16 Wash. 499, 48 P. 333.)

## II.

**A PROMISE TO PAY A NOTE OUT OF AN UNCERTAIN FUND SUCH AS PROFITS OR NET INCOME DOES NOT ACCRUE UNTIL THE EVENT TAKES PLACE AND ACCORDINGLY IS NOT PROVABLE IN BANKRUPTCY.**

It is the law of both California and in bankruptcy that a *promise* to pay a debt out of an uncertain fund, such as profits or income to be earned, is conditioned, and no cause of action accrues thereon until the condition is performed. Accordingly, such a claim is not provable in bankruptcy if the fund never arises or condition never takes place.

*Thompson v. England* (1955 9th Cir.), 226 F. 2d 488 bears out this point. Appellant loaned her husband, the bankrupt, $12,000 of her separate property to be repaid from the proceeds of his business "as soon as said business is in sound financial position." The business never succeeded and following bankruptcy appellant filed her claim for the amount of the loan. In confirming the Referee in Bankruptcy's order disallowing appellant's claim the Court said:

> "Several federal cases have held that bankruptcy does not anticipatorily breach a contract where the liability is contingent on the existence of a fund or profits. In California where one promises to pay when able, essentially the promise here, the obligation does not arise until the debtor is able to pay and there is no duty or obligation to create such ability." (pp. 491-492.)

And similarly in *In re The Literary Digest* (1939, 2nd Cir.), 105 F. 2d 957, the Court said:

"It is conceded that a promise to pay out of an uncertain fund, such as income to be earned, creates no claim provable in bankruptcy, if the fund never arises. *Synnott v. Tombstone Consolidated Mines Co.,* 9 Cir., 208 F. 251; *In re 35% Automobile Supply Co.,* D.C., 247 F. 377; *G. B. McAbee Powder & Oil Co. v. Penn-American Gas Coal Co.,* D. C., 19 F.2d 151" (p. 959).

See also:

*Horacek v. Smith* (1948), 33 Cal. 2d 186, 199 F. 2d 929;

*Van Buskirk v. Kuhns* (1913), 164 Cal. 472, 129 P. 587, 44 L.R.A., N.S., 710.

In the matter of Leonard Plumbing & Heating Supply, Inc. it was testified by Mr. Robert H. Laborde, accountant for the bankrupt, that the business was changed from a partnership into a corporation at his suggestion as a tax savings or tax protection device (TR pp. 150-152); that he recommended the creation of the promissory notes in favor of J. A. Fazio and L. C. Ambrose, claims for which the trustee in bankruptcy now protests. (TR p. 150.) He further testified that these notes were to be paid *out of the profits of the business,* if and when such profits arose. (TR pp. 170, 173-174.) It is conceded that there were no profits out of which such claims could have been paid. Accordingly, the notes which form the basis of the claims of J. A. Fazio and L. C. Ambrose fall within the above rule and are not provable in bankruptcy.

## CONCLUSION.

In conclusion, the Trustee urges that the order of the District Court affirming the referee's order be reversed with directions that the claims of J. A. Fazio and Lawrence C. Ambrose be either subordinated to those of the other general creditors under the Deep Rock Doctrine and succeeding cases noted above, or that they be entirely disallowed under the doctrine that such claims, being conditioned upon the existence of an uncertain fund or event, are not provable in bankruptcy under the line of cases noted immediately above.

Dated, San Francisco, California,
August 30, 1957.

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